Starting Up: Some of the Basics

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Sponsored by the Lawrence Berkeley National Laboratory

March 2, 2016
*Caveat to this presentation: Observations and insights are framed exclusively in the context of a U.S. venture-backed startup company.
Global VC Investment in World Nations in 2015

(Equity Value, $Bn)

- United States: 66.6 $Bn, 49.3%
- Canada: 4.3 $Bn, 3.2%
- United Kingdom: 3.5 $Bn, 2.6%
- China: 38.4 $Bn, 28.4%
- India: 5.4 $Bn, 4.0%

Global VC Investment in 2015, as measured by equity value, was up to 135.2 $Bn.

Source: Thomson ONE Banker
VC Industry In The U.S Today
Regional Investment Dollars In The United States Q4 2015

Source: DowJones

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Some Good News: The Cost To Start A Company 1995 To Present

<table>
<thead>
<tr>
<th>Year</th>
<th>Startup Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>$5 Million</td>
</tr>
<tr>
<td>2005</td>
<td>$500K</td>
</tr>
<tr>
<td>2010</td>
<td>$50K</td>
</tr>
<tr>
<td>2014</td>
<td>$5K</td>
</tr>
</tbody>
</table>
And the Bad News: The VC Financing—Getting Through The Funnel

- **2,000 Leads**
- **300 Meetings**
- **150 Actively Pursued**
- **20–50 Financed**

**Only 1–2% of all leads get funded**

*Source: Goldman Sachs Merchant Banking*
Top 20 Reasons Startups Fail
Based on an Analysis of 101 Startup Post-Mortems

- No Market Need: 42%
- Ran Out of Cash: 29%
- Not the Right Team: 23%
- Get Outcompeted: 19%
- Pricing/Cost Issues: 18%
- Poor Product: 17%
- Need/Lack Business Model: 17%
- Poor Marketing: 14%
- Ignore Customers: 14%
- Product Mis-Timed: 13%
- Lose Focus: 13%
- Disharmony on Team/Investors: 13%
- Pivot gone bad: 10%
- Lack Passion: 9%
- Bad Location: 9%
- No Financing/Investor Interest: 8%
- Legal Challenges: 8%
- Don't Use Network/Advisors: 8%
- Burn Out: 8%
- Failure to Pivot: 7%
Fundraising
Financing Options for First Financing

**Before:**
- Friends and family
- Angels
- Super Angels
- Micro VCs
- Incubators
- Accelerators
- Stage-agnostic VC firms
- Corporate investors

**Now:**
- Friends and family
- Angels
- Super Angels
- Micro VCs
- Incubators
- Accelerators
- Stage-agnostic VC firms
- Corporate investors
- Crowdfunding
- “Demo Day” pitch competitions
- Cross-over firms
- Investment banks
- Hedge funds, mutual funds
- Private equity firms
- Government business development centers
Do you expect it to get harder or easier to raise venture capital in the next 12 months?

- MUCH HARDER: 10%
- SOMewhat HARDER: 56%
- NEITHER HARDER NOR EASIER: 31%
- SOMEWHAT EASIER: 3%
- MUCH EASIER: <1%

How many venture firms did you pitch when raising your last round of capital?

- INSIDE ROUND: 10%
- <3: 12%
- 3-5: 17%
- 6-10: 20%
- 11-20: 22%
- 21-30: 9%
- 30+: 10%

Source: First Round Review, December 2, 2015; survey of 500 CEOs
Angel Groups

- Behave like institutional VCs in many dimensions (e.g. criteria for investment, operational and market diligence or marketing for deal flow)
- However, angel groups have different organizational and governance structures and different investment philosophies

Examples:

- “Super Angels” or “Micro VC’s”
  - Individuals who build funds with small groups of limited partners

Images of various angel group logos are shown.

Examples:

- Bond of Angels
- Sand Hill Angels
- Keiretsu Forum
- Life Science Angels
- Floodgate
- SVAngel
- Felicis Ventures
- 500 Startups
- DST

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There are hundreds of incubators/accelerators in the SF Bay Area alone; more than 2,000 in the United States.

**Distinction**
- Incubators: Founders with an idea and a PPT. Most companies are at the planning, team-building and pre-funding stage.
- Accelerators: Companies that have some level of funding and some product development in motion.

**Examples:**
- RocketSpace
- Techstars
- Y Combinator
- Idealab
- Plug and Play
## The Tradeoffs Of Using Incubators And Accelerators

<table>
<thead>
<tr>
<th>What you get</th>
<th>What you give up</th>
</tr>
</thead>
<tbody>
<tr>
<td>Space (desks, lights, office equipment, security)</td>
<td>“Real estate model” (rent): Usually tied to the amount of space taken up by the company.</td>
</tr>
<tr>
<td>Mentorship (coaching, speakers, panel events)</td>
<td>“Equity model”: 2-10%, with the median in the 3-6% range (where equity is required at all). (e.g., YC wants 7% for $120K—with conditions)</td>
</tr>
<tr>
<td>Cohort environment (rubbing shoulders, sharing ideas with other founders)</td>
<td>Loyalty of employees: Employees may leave for greener pastures within the same incubator or accelerator</td>
</tr>
<tr>
<td>Access (programmers, co-founders, vendors, consultants, etc.)</td>
<td>Autonomy and performance requirements: Usually subject to progress requirements, growth constraints, time boundaries imposed by the incubator</td>
</tr>
<tr>
<td>Money: Sometimes seed money is given as an outright grant, other times it is structured as payment for equity</td>
<td></td>
</tr>
<tr>
<td>Prestige: Tied to the prestige of the incubator, e.g., Y-Combinator, 500Startups, etc.</td>
<td>Loyalty of the incubator: Little diligence on participant companies; modest capital investment; no commitment for follow-on capital; little reason to keep startup in the incubator absent business traction.</td>
</tr>
</tbody>
</table>
Sources of Early Capital
Crowdfunding

Equity-based Model
- FundersClub
- AngelList

Debt-based Model
- LendingClub
- Prosper

Reward-based Model
- Kickstarter
- indiegogo

Investors
Crowdfunding Website
Entrepreneurs
The Up- And Down-side Of Equity-based Crowdfunding

* Up-side
  * Cheap capital
  * Hypothesis testing and proof of concept
  * Marketing

* Down-side
  * Regulatory uncertainties
  * Know your investors?
  * Signaling to institutional investors?
### Evolution of the Financing Model for Early Stage Companies

**Before:**
- **Seed:**
  - Angels only
  - $.2m-$1.5m raise
  - 5-15% equity
  - Pre-$: $1.5m-$3m
  - Partial mgmt team
  - Prototype or concept
  - No revenue
- **Series A:**
  - VC’s only
  - $5m-$10m raise
  - Pre-$: $5m-$8m
  - Core mgmt team
  - MVP, beyond beta
  - First customers
  - Early revenue

**Today:**
- **Seed:**
  - VC’s and select angels
  - $1m-$5m raise
  - 15-20% equity
  - Pre-$: up to $5m
  - Core mgmt team
  - MVP, beyond beta
  - Customers, revenue
- **Series A:**
  - VC’s only
  - $8m-$10m raise
  - 25-40% equity
  - Pre-$: $10m-$15m
  - Core mgmt team
  - Repeatable revenue
  - Growing customers

**Amount Raised**
- **“Pre-seed”:**
  - Angels only
  - $100k-$500k raise
  - Co-founders
  - Prototype or concept

- **Today:**
  - Seed:
  - VC’s and select angels
  - $1m-$5m raise
  - 15-20% equity
  - Pre-$: up to $5m
  - Core mgmt team
  - MVP, beyond beta
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- **Series A:**
  - VC’s only
  - $8m-$10m raise
  - 25-40% equity
  - Pre-$: $10m-$15m
  - Core mgmt team
  - Repeatable revenue
  - Growing customers
The founder’s perspective — The benefits of a convertible note:

<table>
<thead>
<tr>
<th>Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Relatively easy documentation (15 pages of legal documents vs. 100 pages for equity financing)</td>
</tr>
<tr>
<td>• Faster to put in place (2 days vs. 2 weeks+)</td>
</tr>
<tr>
<td>• Sometimes only a single counsel is required to “represent” both sides</td>
</tr>
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<td>• Little negotiation required (convertible debt terms are mostly standard)</td>
</tr>
<tr>
<td>• Cheaper (legal fees &lt; $10k vs. &gt; $25k+)*</td>
</tr>
<tr>
<td>• No valuation required (nor other equity-type deal terms); except for the cap</td>
</tr>
<tr>
<td>• No impact on common stock pricing for employees/consultants</td>
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</tbody>
</table>

*Company always pays its own legal costs plus legal costs for investors’ counsel.*

Anecdotally, most seed financings (i.e., 80% or so where the seed is less than around $1m) are structured through the sale of convertible notes, not as preferred stock financings.
Fundraising: The Process

* What is the general process?
  * Introduction and initial contact with the VC
  * Initial due diligence by VC
  * A meeting with the VC
  * VC follow-up diligence: Contacts with consultants, customers, market research firms, etc.
  * Term sheet issued
  * 30-90 days of extensive DD
  * First Closing

* How long was your entire fundraising process for your most recent round?

Source: First Round Review, December 2, 2015; survey of 500 CEOs
Importance of the Executive Summary

- Executive Summary
  * Opening paragraph: The one-minute test
  * Content: The ten minute test
  * Not to exceed 2 pages! (better if 1 page)

- Must provoke immediate interest
  * Currently unsolved industry problem
  * Size of market
  * Solution to problem
  * Execution strategy
  * Competition
  * Financial projection
  * Management team credentials
Valuation
How the game is played:

Sequoia Capital will provide you with $4 million in exchange for Series A Preferred stock.

How much is your company worth before the financing transaction (i.e., the pre-money valuation)? I.e., how much equity in your company do you have to give up to get the $4 million?

You think your company is worth $8 million in pre-money valuation.

Sequoia thinks $6 million.

Now what?
Valuation of Start-up Companies

* Valuing Start-up Companies: Methodologies

* The Venture Capital Method
* Comparable Company Method
VC required IRR: 50%
Amount of investment: $3.5m
Term of investment: 5 years
Projected net income: $2.5m
P/E multiple: 15x
Outstanding shares: 1,000,000

Value in 5 Years
$2.5m x 15 = $37.5m

Today
Year 5

Management and Employees 29%
VC 71%

discount rate = 50%
**Comparable Company Method**

- Look for other firms with similar “value characteristics”
  - Risk
  - Growth rate
  - Capital structure
  - Size and timing of cash flows

- Select an appropriate comparable
  - P/E multiples
  - EBIT & EBITDA multiples
  - Revenue multiples
  - Book value multiples

- Databases
  - Crunchbase
  - CB Insights
VC Industry In The U.S Today
Median Pre-money Valuations By Round Class ($M) (Annual)

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<tbody>
<tr>
<td>Later Stage</td>
<td>$400.0</td>
<td>$205.0</td>
<td>$95.6</td>
<td>$75.0</td>
<td>$67.9</td>
<td>$45.6</td>
<td>$38.5</td>
<td>$55.4</td>
<td>$44.4</td>
</tr>
<tr>
<td>Second Round</td>
<td>$57.1</td>
<td>$34.7</td>
<td>$23.6</td>
<td>$25.0</td>
<td>$19.5</td>
<td>$13.9</td>
<td>$17.7</td>
<td>$19.1</td>
<td>$17.9</td>
</tr>
<tr>
<td>First Round</td>
<td>$10.0</td>
<td>$8.5</td>
<td>$5.7</td>
<td>$7.2</td>
<td>$5.5</td>
<td>$5.5</td>
<td>$6.0</td>
<td>$6.1</td>
<td>$7.3</td>
</tr>
<tr>
<td>Seed Round</td>
<td>$3.6</td>
<td>$3.9</td>
<td>$2.0</td>
<td>$2.7</td>
<td>$2.8</td>
<td>$2.1</td>
<td>$2.1</td>
<td>$2.3</td>
<td>$2.0</td>
</tr>
</tbody>
</table>
Will You Be My Co-Founder?

- “Co-Founder” or “Early Employee”
  - Qualities: What does it take to be a co-founder?
  - Differences in roles and capabilities
  - Present vs. future capabilities: Scaling with growth

- Composition and size of the founding team

- Who cares? What’s the difference between a co-founder and an early employee?
A very general rule of thumb for non-founder employees in a “mid-stage” technology start-up (i.e., post-Series A)

<table>
<thead>
<tr>
<th>Position</th>
<th>No. of Ees</th>
<th>% of Capital</th>
<th>Aggregate Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>* CEO (1):</td>
<td>5-10%</td>
<td>7%</td>
<td></td>
</tr>
<tr>
<td>* CFO (1):</td>
<td>1 - 2%</td>
<td>1%</td>
<td></td>
</tr>
<tr>
<td>* VPs (3):</td>
<td>1 - 3%</td>
<td>8%</td>
<td></td>
</tr>
<tr>
<td>* Director-level (6):</td>
<td>&lt;1/2%</td>
<td>3%</td>
<td></td>
</tr>
<tr>
<td>* Others (?):</td>
<td>&lt;1/4%</td>
<td>6%</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>25%</strong></td>
<td></td>
</tr>
</tbody>
</table>
* You have a choice: general partnership, limited partnership, limited liability corporation, benefit corporation, Subchapter S corporation, Subchapter C corporation

* From an Entrepreneur’s Perspective
  * Both an LLC and a Subchapter S corporation can be used when (i) the entity will have very few owners in the first phase; (ii) the company will generate operating losses; and (iii) the owners uniformly want tax benefits associated with the losses

* From a VC’s Perspective
  * VC firms will rarely invest in an LLC!
  * VC firms by definition cannot invest in a Subchapter S corporation

* VC-backed companies are almost invariably (98% of the time?) Subchapter C corporations
  * Mainstream practice is to incorporate in Delaware as a Sub C at the start
- Common stock is typically used for compensatory purposes (i.e., employees, consultants, board members, etc.)
- Preferred stock is typically set aside as the vehicle for investment
## I. Formation of a Start-up Company

<table>
<thead>
<tr>
<th>Person</th>
<th>No. of Shares</th>
<th>% of Shares</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founder A</td>
<td>1,000,000</td>
<td>33.33%</td>
<td>$1,000</td>
</tr>
<tr>
<td>Founder B</td>
<td>1,000,000</td>
<td>33.33%</td>
<td>$1,000</td>
</tr>
<tr>
<td>Founder C</td>
<td>1,000,000</td>
<td>33.33%</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

Total Post-Financing Valuation: 3,000,000

![Pie chart showing equity distribution among founders:]

- Founder A: $1,000, 33.3%
- Founder B: $1,000, 33.3%
- Founder C: $1,000, 33.3%
II. Hiring of Chief Executive Officer & Establishment of Option Plan

- Reason for Dilution: Stock incentive provision.
- Price (Pre-financing Valuation): $0.01/share ($30,000)

<table>
<thead>
<tr>
<th>Person</th>
<th>No. of Shares</th>
<th>% of Shares</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founder A</td>
<td>1,000,000</td>
<td>20.0%</td>
<td>$10,000</td>
</tr>
<tr>
<td>Founder B</td>
<td>1,000,000</td>
<td>20.0%</td>
<td>$10,000</td>
</tr>
<tr>
<td>Founder C</td>
<td>1,000,000</td>
<td>20.0%</td>
<td>$10,000</td>
</tr>
<tr>
<td>President</td>
<td>1,000,000</td>
<td>20.0%</td>
<td>$10,000</td>
</tr>
<tr>
<td>Stock Opt. Plan</td>
<td>1,000,000</td>
<td>20.0%</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

Total Post-Financing Valuation 5,000,000 100.0% $50,000
### III. Initial Venture Financing Round

- **Reason for Dilution:** First round fundraising for product development.
- **Price (Pre-financing Valuation):** $2.00/share ($10,000,000)

<table>
<thead>
<tr>
<th>Person</th>
<th>No. of Shares</th>
<th>% of Shares</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founder A</td>
<td>1,000,000</td>
<td>10.0%</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Founder B</td>
<td>1,000,000</td>
<td>10.0%</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Founder C</td>
<td>1,000,000</td>
<td>10.0%</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>President</td>
<td>1,000,000</td>
<td>10.0%</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Stock Opt. Plan</td>
<td>1,000,000</td>
<td>10.0%</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Series A Inv.</td>
<td>5,000,000</td>
<td>50.0%</td>
<td>$10,000,000</td>
</tr>
<tr>
<td><strong>Total Post-Financing Valuation</strong></td>
<td><strong>10,000,000</strong></td>
<td><strong>100.0%</strong></td>
<td><strong>$20,000,000</strong></td>
</tr>
</tbody>
</table>
### IV. Series B Preferred Stock Financing

- **Reason for Dilution:** Second round fundraising for product development.
- **Price (Pre-financing Valuation):** $4.00/share ($40,000,000)

<table>
<thead>
<tr>
<th>Person</th>
<th>No. of Shares</th>
<th>% of Shares</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founder A</td>
<td>1,000,000</td>
<td>6.66%</td>
<td>$4,000,000</td>
</tr>
<tr>
<td>Founder B</td>
<td>1,000,000</td>
<td>6.66%</td>
<td>$4,000,000</td>
</tr>
<tr>
<td>Founder C</td>
<td>1,000,000</td>
<td>6.66%</td>
<td>$4,000,000</td>
</tr>
<tr>
<td>President</td>
<td>1,000,000</td>
<td>6.66%</td>
<td>$4,000,000</td>
</tr>
<tr>
<td>Stock Opt. Plan</td>
<td>1,000,000</td>
<td>6.66%</td>
<td>$4,000,000</td>
</tr>
<tr>
<td>Series A Investor</td>
<td>5,000,000</td>
<td>33.33%</td>
<td>$20,000,000</td>
</tr>
<tr>
<td>Series B Investor</td>
<td>5,000,000</td>
<td>33.33%</td>
<td>$20,000,000</td>
</tr>
<tr>
<td><strong>Total Post-Financing Valuation</strong></td>
<td><strong>15,000,000</strong></td>
<td><strong>100.0%</strong></td>
<td><strong>$60,000,000</strong></td>
</tr>
</tbody>
</table>
The Evolving Capital Structure

V. Initial Public Offering

- Reason for Dilution: IPO for expansion of manufacturing and marketing.
- Price (Pre-financing Valuation): $20.00/share ($300,000,000)

<table>
<thead>
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<th>No. of Shares</th>
<th>% of Shares</th>
<th>Value</th>
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</thead>
<tbody>
<tr>
<td>Founder A</td>
<td>1,000,000</td>
<td>5%</td>
<td>$20,000,000</td>
</tr>
<tr>
<td>Founder B</td>
<td>1,000,000</td>
<td>5%</td>
<td>$20,000,000</td>
</tr>
<tr>
<td>Founder C</td>
<td>1,000,000</td>
<td>5%</td>
<td>$20,000,000</td>
</tr>
<tr>
<td>President</td>
<td>1,000,000</td>
<td>5%</td>
<td>$20,000,000</td>
</tr>
<tr>
<td>Stock Opt. Plan</td>
<td>1,000,000</td>
<td>5%</td>
<td>$20,000,000</td>
</tr>
<tr>
<td>Series A Investor</td>
<td>5,000,000</td>
<td>25%</td>
<td>$100,000,000</td>
</tr>
<tr>
<td>Series B Investor</td>
<td>5,000,000</td>
<td>25%</td>
<td>$100,000,000</td>
</tr>
<tr>
<td>Public Investors</td>
<td>5,000,000</td>
<td>25%</td>
<td>$100,000,000</td>
</tr>
<tr>
<td>Total Post-Financing Valuation</td>
<td>20,000,000</td>
<td>100.0%</td>
<td>$400,000,000</td>
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</table>
Last thoughts:

Circulate

Educate

Triangulate